

REDACTED – FOR PUBLIC INSPECTION

June 28, 2017

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: *Telecommunications Relay Services and Speech-to-Speech Services for Individuals with Hearing and Speech Disabilities*, CG Docket No. 03-123; *Structure and Practices of the Video Relay Service Program*, CG Docket No. 10-51

Dear Ms. Dortch:

In accordance with the *Second Protective Order* for the above-referenced proceedings, Sorenson Communications, LLC (“Sorenson”) herein submits a redacted version of the attached ex parte in the above-referenced proceedings.

Sorenson has designated for highly confidential treatment the marked portions of the attached documents pursuant to the *Second Protective Order* in CG Docket Nos. 03-123 and 10-51.¹ Sorenson’s ex parte includes granular data with respect to costs that has previously been designated as highly confidential.² As such these materials fall under the following enumerated items in Appendix A of the *Second Protective Order*:

2. Information that provides granular information about a Submitting Party’s past, current or future costs, revenues, marginal revenues, or market share, and future dividends.

Sorenson’s ex parte also includes highly confidential information that has been previously filed by ZVRS.

Pursuant to the protective order and additional instructions from Commission staff, Sorenson is filing a redacted version of the document electronically via ECFS, one copy of the

¹ *Structure and Practices of the Video Relay Service Program; Telecommunications Relay Services and Speech-to-Speech Services for Individuals with Hearing and Speech Disabilities*, Second Protective Order, DA 12-858, 27 FCC Rcd. 5914 (Cons. & Gov’t Affs. Bur. 2012).

² See Letter from John T. Nakahata, Counsel to Sorenson Communications, LLC, to Marlene H. Dortch, Secretary, FCC, CG Docket Nos. 10-51 and 03-123 (filed May 5, 2017).

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Highly Confidential version with the Secretary, two copies of the redacted version with the Secretary, and sending copies of the highly confidential version to Eliot Greenwald and Robert Aldrich of the Consumer and Governmental Affairs Bureau and the TRS Reports mailbox.

Please contact me if you have any questions or require any additional information.

Sincerely,



John T. Nakahata
Counsel to Sorenson Communications, LLC

Attachment

cc: Eliot Greenwald
Robert Aldrich
TRSReports@fcc.gov

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Ex Parte

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: *Telecommunications Relay Services and Speech-to-Speech Services for Individuals with Hearing and Speech Disabilities*, CG Docket No. 03-123; *Structure and Practices of the Video Relay Service Program*, CG Docket No. 10-51

Dear Ms. Dortch:

Sorenson Communications, LLC (“Sorenson”) files this letter in response to ex parte submissions by ZVRS Holding Company, the parent of CSDVRS (“ZVRS”) and Purple Communications, LLC (“Purple”) dated June 6, 2017, June 21, 2017, and June 23, 2017.¹ The ZVRS ex partes make clear that ZVRS is really asking the Commission to adopt *de facto* provider-specific VRS rates, both through its proposed tier rates and volume levels and in its contention that it must be permitted to “double-dip” the tiers by applying them separately to each of its operating subsidiaries. ZVRS points to no Commission precedent in which the Commission has permitted competitors offering the same services in the same geographic areas to charge different rates when the only ascertainable difference in underlying costs is that one provider is more efficient. Yet that is exactly what ZVRS proposes—that the Commission adopt rate tiers constructed deliberately to provide higher compensation to ZVRS, the second largest operator of VRS across the country, even though the cost differences on which ZVRS bases its request are entirely related to efficiency, i.e., claimed economies of scale. Moreover, it is clear from ZVRS’ June 6 ex parte that its plea for special relief is based in large part *****BEGIN**

¹ See Letter from Gregory Hlibok, Chief Legal Office, ZVRS Holding Company, to Marlene H. Dortch, Secretary, FCC, CG Docket Nos. 10-51 & 03-123 (filed June 6, 2017) (“ZVRS June 6 Ex Parte”); Letter from Gregory Hlibok, Chief Legal Office, ZVRS Holding Company, to Marlene H. Dortch, Secretary, FCC, CG Docket Nos. 10-51 & 03-123 (filed June 21, 2017); Letter from Gregory Hlibok, Chief Legal Office, ZVRS Holding Company, to Marlene H. Dortch, Secretary, FCC, CG Docket Nos. 10-51 & 03-123 (filed June 23, 2017).

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HIGHLY CONFIDENTIAL*** [REDACTED] *****END HIGHLY CONFIDENTIAL*****. There is simply no way that ZVRS’ plea for special treatment based on its own inefficient cost structure can be reconciled with Section 225’s requirement that TRS be provided “in the most efficient manner.” As Professor Bagenstos has set forth, the words “in the most efficient manner” in Section 225 mean that “when there are two alternative means of providing relay services that are functionally equivalent to each other, the Commission may require that a user receive the less expensive of the two alternatives.”² And as the Commission stated in 2013, “inefficient VRS operations requiring higher compensation rates are inconsistent with the sound management of the TRS Fund.”³

The Commission has, for nearly three decades, been moving away from ratemaking based on provider-specific costs—and with good reason. The Commission diagnosed the problem accurately in 1989, when it first introduced price-cap regulation:

Although carriers subject to [provider-specific rate-of-return] regulation are limited to earning a particular percentage return on investment during a fixed period, a carrier seeking to increase its dollar earnings often can do so merely by increasing its aggregate investment. In other words, under a rate of return regime, profits (i.e., dollar earnings) can go up when investment goes up. This creates a powerful incentive for carriers to “pad” their costs, regardless of whether additional investment is necessary or efficient. And, because a carrier’s operating expenses generally are recovered from ratepayers on a dollar-for-dollar basis, and do not affect shareholder profits, management has little incentive to conserve on such expenses. This creates an additional incentive to operate inefficiently.⁴

Even in a nominally price-capped system, these incentives can still be present if providers believe that they can influence their own rates if they increase their costs.

² Samuel R. Bagenstos, *The Proper Interpretation of “In the Most Efficient Manner” in Title IV of the Americans with Disabilities Act*, at 2 (May 26, 2017), attached to Letter from Christopher J. Wright, Counsel to Sorenson Communications, LLC, CG Docket Nos. 03-123 & 10-51 (filed June 13, 2017).

³ *Telecommunications Relay Services and Speech-to-Speech Services for Individuals with Hearing and Speech Disabilities; Structure and Practices of the Video Relay Service Program*, FCC 13-82, 28 FCC Rcd. 8618, 8698 ¶ 197 (2013) (“VRS Reform Order”).

⁴ *Policy and Rules Concerning Rates for Dominant Carriers*, FCC 89-91, 4 FCC Rcd. 2873, 2889-90 ¶ 30 (1989) (“AT&T Price Cap Order”).

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BEGIN HIGHLY CONFIDENTIAL [REDACTED]

[REDACTED] ***END HIGHLY CONFIDENTIAL***⁵ This is occurring even though ZVRS is consolidating its ZVRS and Purple subsidiaries, which it must complete by February 2020. The potential to obtain provider-specific rates creates an incentive not to reduce costs quickly—and in fact disincentivizes pursuit or even identification of efficiencies prior to the setting of new rates.

There is no economic justification, nor any Commission precedent, that justifies setting different rates for providers serving the same market, as is the case in VRS, in which all VRS providers serve all deaf users nationwide. Economics teaches that a competitive market will generate a single market-clearing price, based, when providers' costs vary, on the costs of the second-lowest cost provider.⁶ As Sorenson pointed out in its comments, when the Commission used rate-of-return methodologies for rural incumbent local exchange carriers ("ILECs"), it did so on the basis of company-specific costs because each incumbent LEC by definition was the pre-1996 monopoly telephone provider in its territory: each served a unique territory, which would have different underlying cost characteristics such as geography, demography, terrain, soil types, climate, etc.⁷ But the Commission has never applied different rates to providers serving

⁵ See ZVRS June 23, 2017 Ex Parte, Attachment at 2. ZVRS' June 6 Ex Parte demonstrates that its request for special relief is based not only ***BEGIN HIGHLY CONFIDENTIAL*** [REDACTED]

[REDACTED] ***END HIGHLY CONFIDENTIAL*** See ZVRS June 6 Ex Parte, Attachment. While Sorenson agrees that the Commission excludes too many legitimate costs, the Commission cannot pick and choose to recognize different costs for different providers. That would be arbitrary and capricious.

⁶ See Ross Baldick, *Single Clearing Price in Electricity Markets*, at 1 (Feb. 18, 2009), <ftp://www.cramton.umd.edu/papers2005-2009/baldick-single-price-auction.pdf>; see also *An Economic Analysis of VRS Policy Reform: Declaration of Michael Katz* ¶ 70, attached as Appendix A to Comments of Sorenson Communications, Inc., CG Docket Nos. 10-51 & 03-123 (filed Mar. 9, 2012).

⁷ See Comments of Sorenson Communications, LLC, Regarding Section IV.A-B and F of the Further Notice of Proposed Rulemaking at 45-46, CG Docket Nos. 10-51 & 03-123 (filed Apr. 24, 2017) ("Sorenson Comments"); see also Jonathan E. Nuechterlein and Philip J. Weiser, *DIGITAL CROSSROADS* 33-34, 2nd ed., 2013.

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the same markets with the same underlying cost characteristics unrelated to differences in efficiency.

For instance, when the Commission set rules to regulate interstate access charges charged by CLECs, it generally capped CLECs at the rates charged by the competing incumbent local exchange carrier.⁸ Although the Commission created an exemption to the generally applicable benchmark for carriers considered to be rural CLECs, which are competitive LECs serving exclusively rural areas, and allowed them to charge higher rates than the competing non-rural ILEC, the Commission expressly took that step because the non-rural ILEC was required to charge averaged rates across both rural and urban areas, and thus the rate charged for a rural area alone, if benchmarked to the non-rural ILEC, would be too low.⁹ As the Commission observed, “The same increase in access rates would occur if, rather than entering an area as a competitive carrier, a small local-service provider were to purchase a rural exchange and thus become the rural ILEC serving the end users in that exchange.”¹⁰ Thus, the permitted rate differential in that case was justified by the different cost characteristics of the competing non-rural ILEC’s larger urban and rural service area, averaged together, and the cost characteristics of the rural CLEC’s rural-only service area. Again, nothing comparable exists in VRS, in which all providers compete nationwide for the same pool of ASL-speaking deaf users.

The D.C. Circuit’s recent decision in *Global Tel*Link* also does not justify provider-specific rates based solely on providers’ differing levels of efficiency. In that case, “the cost to provide [Inmate Calling Services, i.e., outbound prison phone service] varie[d] widely on the basis of regional differences, such as the age and condition of a given facility or the specific security features that correctional authorities demand.”¹¹ Since “the record show[ed] that regional variation, not efficiency, account[ed] for cost discrepancies among providers,” the Court ruled that a single rate cap, based on averaged costs, was unreasonable.¹² But the Court did not in any way preclude the use of averaged costs to set rates when cost discrepancies are based on

⁸ See *Access Charge Reform; Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, Seventh Report and Order and Further Notice of Proposed Rulemaking, FCC 01-146, 16 FCC Rcd. 9923, 9944-45, 9965 ¶¶ 52, 108 (2001). Technically, the cap was effectuated as a tariffing rule, governing when a CLEC could validly tariff rates. Because CLECs generally charged rates by tariff rather than contract, this effectively capped CLEC access charge rates.

⁹ See *id.* ¶¶ 64-67.

¹⁰ *Id.* ¶ 67.

¹¹ *Global Tel*Link v. FCC*, No. 15-1461, 2017 WL 2540899, at *12 (D.C. Cir. June 13, 2017).

¹² *Id.* at *13.

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efficiency, not on discernable regional variations. And no VRS provider has pointed to any discernable regional cost variations—nor could they because they all compete nationally.

In fact, it would be arbitrary and capricious to ignore the fact that cost differences stem from variations in efficiency, and thus to set differential rates that reward inefficiency. As the Commission has observed, provider-specific cost-based rate-of-return rates create “little incentive to conserve on such expenses.”¹³ Even characterizing such a system as lagged rate-of-return does not help: “Regulatory lag produces none of the rate decreases that the proposed incentive system provides through the operation of our overall incentive-based plan”¹⁴ As Sorenson explained in detail in its comments and reply comments in response to the *Further Notice of Proposed Rulemaking* currently under consideration, tiers to support subscale competitors are wasteful, incentivize providers to stay small rather than to grow, and should be phased out, not expanded.¹⁵ Tiers have now been in existence for ten years. The Commission has yet to articulate why it is rational to maintain, for such a long period, rates set on a *de facto* provider-specific rate-of-return basis, when the Commission has eschewed that form of rate setting for good, well-articulated reasons when setting other rates. As Sorenson has previously argued, the Commission should strive to establish rates that emulate a competitive market—which would neither produce pro-competitor (but not pro-competition) rate tiers nor employ a rate-of-return methodology (particularly one that ignores many costs and provides no margin on expenses, as the long-dormant VRS rate-of-return methodology would do).

Notably, when the Commission was considering reforms to its high-cost universal service program, it determined that it would only support one network in areas that were so costly that, in the absence of support, no networks would be built. The Commission decided against subsidizing competition in these areas, notwithstanding the public benefits that ordinarily flow from market competition.¹⁶ Similarly, in none of the Commission’s universal service support

¹³ *AT&T Price Cap Order*, 4 FCC Rcd. at 2890 ¶ 30.

¹⁴ *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, FCC 90-314, 5 FCC Rcd. 6786, 6791 ¶ 40 (1990) (“*LEC Price Cap Order*”).

¹⁵ See Sorenson Comments at 49-56; Reply Comments of Sorenson Communications, LLC Regarding Section IV.A-B and F of the *Further Notice of Proposed Rulemaking* at 17-23, CG Docket Nos. 10-51 & 03-123 (filed May 4, 2017) (“*Sorenson Reply Comments*”).

¹⁶ See, e.g., *Connect American Fund; A National Broadband Plan for our Future; Establishing Just and Reasonable Rates for Local Exchange Carriers; High-Cost Universal Service Support; Developing an Unified Inter-carrier Compensation Regime; Federal-State Joint Board on Universal Service; Lifeline and Link-Up; Universal Service Reform—Mobility Fund*, Report and Order and *Further Notice of Proposed Rulemaking*, FCC 11-161, 26 FCC Rcd. 17,663, 17,780 ¶ 319 (2011).

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mechanisms does the Commission pay more to a less efficient, higher-cost provider than it pays to a competing more efficient, lower-cost provider. It is only with respect to VRS that the Commission has created support tiers that are designed to prop up high-price providers in the face of lower-priced alternatives to provide the same minutes for the same customer.

Although the Commission has “tolerat[ed] some degree of additional inefficiency in the short term” it has only done so “in order to maximize the opportunity for successful participation of multiple *efficient* providers in the future.”¹⁷ The *VRS Reform Order* contemplated gradually lowering the gap between rates for efficient and inefficient providers in order to allow smaller providers a chance to become more efficient,¹⁸ but the Commission’s goal was to eventually eliminate the need for tiered rates,¹⁹ and it was never the Commission’s intention to permanently establish separate rates that allow all providers to thrive regardless of their inefficiency levels.

If, however, the Commission moves forward with setting rates with tiers that are tied to provider-specific costs, it would be arbitrary and capricious to do so only for ZVRS and Purple, and not for Sorenson. Specifically, it would be arbitrary and capricious to set the Tier III rate below Sorenson’s actual costs plus a reasonable margin.²⁰ As the record in this proceeding shows, Sorenson’s true costs of providing VRS, excluding endpoint costs, including an imputed estimate of intellectual property costs, and applying a 9.5% after tax margin, yields a sustainable Tier III rate of *****BEGIN HIGHLY CONFIDENTIAL***** *****END HIGHLY CONFIDENTIAL***** per minute.²¹ However, as the record also shows, the costs of developing, providing, installing, and maintaining necessary equipment for VRS should be included in the cost calculation. Doing so, and again estimating intellectual property costs and

¹⁷ *VRS Reform Order*, 28 FCC Rcd. at 8699 ¶ 200 (emphasis added).

¹⁸ *See id.*

¹⁹ *See id.* ¶ 199.

²⁰ *See Global Tel*Link* at *11-12 (reversing order as arbitrary and capricious where it failed to consider an actual cost of providing service).

²¹ This is based upon Sorenson’s refiled cost submission, which projects allowable per-minute costs averaging *****BEGIN HIGHLY CONFIDENTIAL***** *****END HIGHLY CONFIDENTIAL***** for calendar years 2017 and 2018, plus *****BEGIN HIGHLY CONFIDENTIAL***** *****END HIGHLY CONFIDENTIAL*****

*****END HIGHLY CONFIDENTIAL*****. Sorenson previously explained the basis for these additional adjustments for numbering costs, intellectual property costs and post-tax margin in its comments. *See* Sorenson Comments at 25-27, 28, 36-39; Sorenson Reply Comments at 15.

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applying a 9.5% after tax margin, yields a rate of ***BEGIN HIGHLY CONFIDENTIAL***
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Moreover, if the Commission is basing Tier III rates in whole (such as by reference only to Sorenson's reported costs) or in significant part (such as through use of an industry weighted average cost per minute of which Sorenson comprises the substantial majority weight) in order to construct rate levels for upcoming years, it cannot rationally ignore inflation.

- There is no basis in the record for concluding that VRS input costs, be they salaries and benefits costs for Video Interpreters, call center managers, customer support or administrative personnel, facilities costs, or the myriad other VRS input costs, will not be subject to inflation. Indeed, Sorenson has described in the record significant factors that will continue to push up VRS costs over the next four years, especially in the area of Video Interpreter wages and benefits, which is uncontradicted.²³
- Sorenson has also placed in the record evidence that there can be no expectation of further significant increases in Video Interpreter efficiency and productivity; those are exhausted.²⁴
- The Commission has never conducted a Total Factor Productivity study of VRS, and thus—unlike when it adopted price caps for incumbent local exchange carriers—it has no basis to assume that productivity increases in VRS will exceed productivity increases in

²² This is computed as follows: Projected allowable per-minute costs averaging ***BEGIN HIGHLY CONFIDENTIAL*** [REDACTED] ***END HIGHLY CONFIDENTIAL*** for calendar years 2017 and 2018, plus ***BEGIN HIGHLY CONFIDENTIAL*** [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] ***END HIGHLY CONFIDENTIAL*** See Sorenson Comments at 40; Sorenson Reply Comments at 14.

²³ See Sorenson Reply Comments at 11-13; Declaration of Christopher Wakeland, VP of Interpreting, Sorenson Communications, LLC ¶¶ 6-7, attached as Exhibit 3 to Sorenson Reply Comments; Sorenson Comments at 21-25; Letter from John T. Nakahata, Counsel to Sorenson Communications, LLC, to Marlene H. Dortch, Secretary, FCC, CG Docket Nos. 10-51 & 03-123, at 1-2 (filed May 18, 2017); Letter from John T. Nakahata, Counsel to Sorenson Communications, LLC, to Marlene H. Dortch, Secretary, FCC, CG Docket Nos. 10-51 & 03-123, at 3-4 (filed May 5, 2017) ("Sorenson May 5 Ex Parte").

²⁴ See Sorenson May 5 Ex Parte, Exhibit 6.

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the economy as a whole, or that input costs will increase more slowly than the economy as a whole.²⁵ Accordingly, there is no basis for any assumption that would justify explicitly or implicitly setting a productivity factor for VRS equal to inflation (i.e., no change in the nominal price cap) —which is the result if the Commission sets rates based on costs reported or projected for a given year and then fails to adjust those costs for inflation in future years. The fact that the Commission has not previously incorporated inflation (or made an explicit X-factor adjustment for productivity) when VRS rates were set at higher levels cannot justify ignoring inflation when setting new rates.

- Finally, there is no basis in the record for the Commission to assume that VRS costs that are not variable with volume will be spread over a significant number of compensable minutes. Overall, VRS usage is not growing significantly, and there is no basis in the record for assuming that Sorenson will significantly increase the proportion of the stagnant VRS calling demand that it serves.

In short, any set of VRS rate caps that did not account for increasing input costs over time due to inflation would be arbitrary and capricious. Setting aside potential merger efficiencies that ZVRS will capture as it integrates its Purple and ZVRS operating subsidiaries, the evidence in the record points in one direction—that average VRS costs per minute, and particularly Sorenson’s VRS costs per minute, will increase over time at least in pace with, or even faster than, inflation in the economy as a whole.

* * *

²⁵ See *Business Data Services in an Internet Protocol Environment; Technology Transitions; Special Access for Price Cap Local Exchange Carriers; AT&T Corporation Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, Report and Order, FCC 17-43, 32 FCC Rcd. 3459, 3544, 3545 ¶¶ 198, 204 (2017); *LEC Price Cap Order*, 5 FCC Rcd. at 6796 ¶ 74.

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For these reasons, the Commission should reject the reasoning of the ZVRS ex parte and should not set VRS rate tiers on a provider-specific basis. If, however, the Commission does again adopt VRS rate tiers, it would be arbitrary and capricious to set the Tier III rate below Sorenson's actual costs of providing VRS plus a reasonable margin.

Sincerely,



John T. Nakahata

Counsel to Sorenson Communications, LLC

cc: Claude Aiken
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